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The European Community: Coping With the Budget Crisis

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An Intelligence Assessment

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EUR 85-10103
June 1985

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The European Community: Coping With the Budget Crisis [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] the Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, European Issues Division, EURA, [redacted]

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The European Community: Coping With the Budget Crisis [redacted]

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Key Judgments

Information available as of 1 May 1985 was used in this report.

The EC faced a severe budget crisis in 1983 and 1984, largely because its spending commitments have progressively outpaced its revenue. The crisis, which nearly paralyzed the Community, has abated temporarily, but it will, in our view, soon resurface.

Last year, the EC was spared insolvency only through emergency loans from member states. We believe that this year the EC will again successfully raise emergency funds to cover a projected revenue shortfall. We also expect the Community to receive a new infusion of cash in 1986 when a mid-1984 agreement to boost Community revenues some 20 percent comes into effect. In our view, however, these new funds will be exhausted by late 1987 because of continuing increases in agricultural spending and additional expenditures associated with EC enlargement.

The Common Agricultural Policy remains the primary cause of the EC's budget problems. The Community adopted a series of reforms in 1984 to curb soaring agricultural spending and take greater account of available revenues when setting farm support prices. In our judgment, these reforms will at best slow the drain on the EC budget; the EC will continue to be plagued with the fundamental problem that its agricultural policy is too expensive.

When EC revenues again run short in 1986 or 1987, we expect the Community to repeat the debilitating battle it fought in 1984 over budget rebates. [redacted] 25X1

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The continuing budget squeeze will, in our judgment, lead the Community to seek external scapegoats for its problems; as a result, the United States is likely to face increased EC protectionism in agriculture, and perhaps in other fields as well. The EC has already proposed restricting imports of US corn gluten feed to alleviate some of the overproduction in EC dairy and grain sectors. Following EC entry of Spain and Portugal, now scheduled for 1 January 1986, the Community may try to impose a domestic tax on vegetable oils and fats—other than olive oil—that would hurt US soybean exports to the EC. The extent of EC agricultural protectionism probably will be limited, however, by internal EC squabbling that will hamper the Twelve's ability to agree on forceful policies.

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In the long run, we believe the budget crisis will impede the institutional development of the EC. It is likely to cause recurrent squabbling among Community members and constrain vital EC programs, forcing members to turn frequently to unilateral solutions to their problems. The budget crisis has, for example, hampered the Community's ability to initiate programs in new areas like high technology. In our view, the budget imbroglio casts doubt on the ability of the EC to proceed substantially further with European integration. Although the EC will survive its many problems and crises, the budget crisis demonstrates that EC members presently lack the political will to push ahead with the kinds of far-reaching joint economic and political policies necessary to transform the Community into a "United States of Europe."

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Introduction

During late 1983 and much of 1984, EC decisionmaking was nearly paralyzed by a budget crisis largely due to agricultural overspending. The impasse riveted the attention of both the EC Commission and the Council—the representatives of the 10 member states—and resulted in a series of embarrassing summit deadlocks. The EC's preoccupation with its budget morass stymied Community efforts to restructure dying industries and promote new high-technology ventures, pushed issues of West European political cooperation onto the back burner, and complicated EC enlargement negotiations. Commentators mused about the emergence of a "two-speed" Europe divided between those countries committed to West European integration and those not. Former Commission President Roy Jenkins expressed the frustration of many when he admonished the Community to "get its head out of the groceries."

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The EC budget crisis also contributed to US-EC trade frictions. As the budget problem grew, the Ten at times tried to vent the strains on the Common Agricultural Policy (CAP) by increasing agricultural protectionism and seeking external scapegoats for unpopular CAP spending cutbacks. The EC sought, for example, to restrict imports of US-produced feed grain substitutes. The Commission also pushed proposals for a domestic tax on vegetable oils—other than olive oil—to increase EC butter consumption and displace imports of US soybeans.

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Problem in Brief

The EC's budget crisis erupted in 1983 because three interrelated problems came to a head at the same time:

- How to fund EC programs over the short term until new revenues are available.
- How to distribute the budget burden fairly among the Ten.
- How to solve the longer term, structural budgetary problem.

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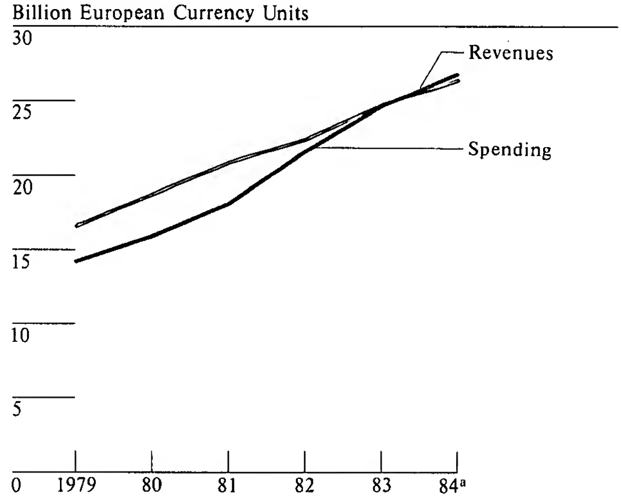
Figure 1
EC Budget: Spending Versus Resources, 1979-84



[a] 1984 revenue shortfall was covered by emergency loans from member states.

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The *short-term problem* arose because in recent years EC spending in European Currency Units (ECUs), which largely took the form of open-ended agricultural payments, outpaced the growth of revenue (see figure 1).[1] In 1983, for example, overall EC spending rose nearly 14 percent while revenue grew 10 percent. Farm spending that year shot up almost 28 percent, spurred by surplus milk and grain production purchased by Community intervention agencies. Farm spending and overall spending continued to rise in

[1] The European Currency Unit, the EC's unit of account, is a currency "basket" that represents the average value of the Community's 10 national currencies, weighted roughly according to the size of the national economies. The average value of the ECU in 1984 was 79 cents.

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1984. Community revenues come largely from tapping member countries' value-added taxes (VAT), but only up to 1 percent of the total take. This ceiling was reached in 1984. The Treaty of Rome, which established the Community, prohibits EC budget deficits, so the Community faced insolvency. The Ten finally agreed last October to temporary loans from member states to cover the 1984 shortfall, and to a higher, 1.4-percent VAT ceiling effective 1 January 1986. The EC almost certainly will have cost overruns again this year, however, so the Ten are confronting the issue of funding another budget gap in 1985.

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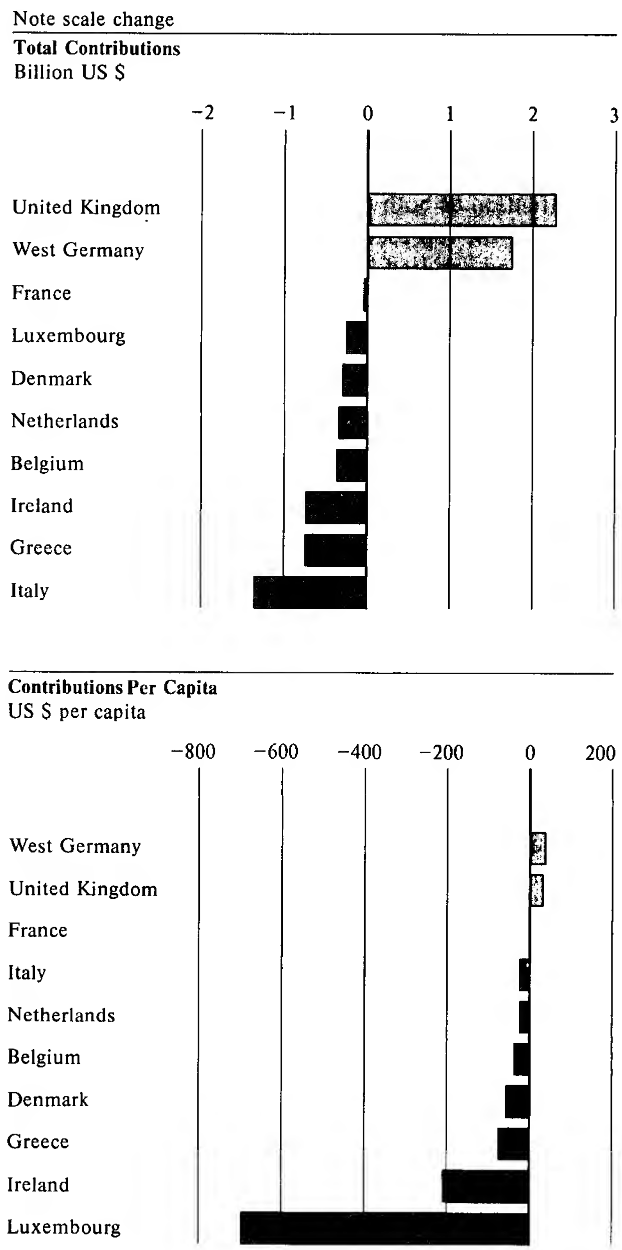
The EC's *longer term, structural budget problem* results from strong pressures to continue boosting farm spending, coupled with a cumbersome and restrictive method for meeting financial commitments. More than 70 percent of Community spending is devoted to farmers, who enjoy considerable political clout and who are accustomed to generous subsidies (see figure 4). Farm prices are set each year by negotiations among agricultural ministers, and until recently without any consideration of available funds. The political pressures on agricultural ministers, who are naturally responsive to their farm constituencies,

Figure 2
EC Members: Net Budget Contributions, 1983[a]



[a] Negative balance indicates a net receipt.

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Figure 3
EC: Common Agricultural Policy Payments by Country, 1983

Percent

Total=US $14.1 billion

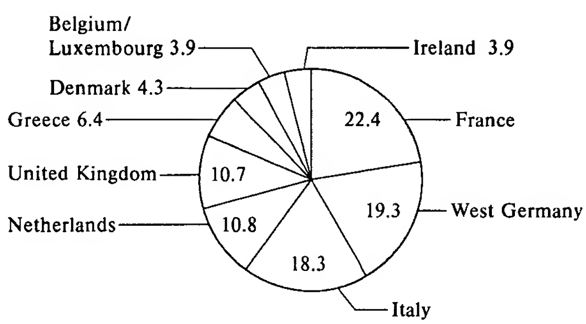

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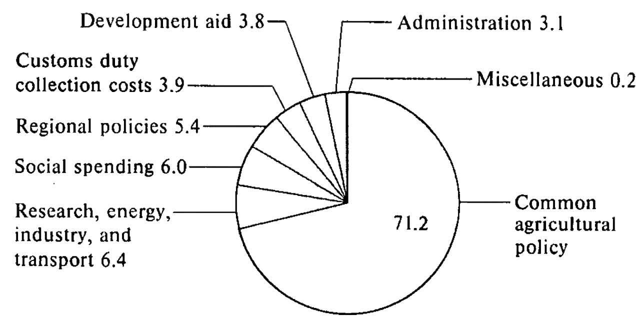
Figure 4
EC: Budget Expenditures, 1984

Percent

Total=US $21.2 billion



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have led to artificially high support prices that have ratcheted EC agricultural spending upward. Under the CAP, the Community stands ready to buy unlimited amounts of most agricultural products at a predetermined price, regardless of the prevailing market price. Since production fluctuates, it is impossible to predict the exact level of CAP payments required in a given year. Moreover, because CAP subsidies have stimulated overproduction in many products, the Community has tried to dispose of some surpluses through export subsidies. EC spending on export subsidies also varies, according to world market prices for commodities.

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EC revenues, on the other hand, are more limited and usually rise slowly (see figure 5). During periods of economic growth, increased domestic spending generates higher VAT revenues. Similarly, increased Community imports from third countries brings the EC more money from customs duties. The only provision for a dramatic leap in EC revenues is an increase in the ceiling on the amount of VAT that EC members agree to make available to the Community. Raising the VAT ceiling requires the Ten's unanimous consent, and gaining approval can prove difficult if one member withholds consent to gain concessions on other issues. The EC did not squarely confront the problem of raising the VAT ceiling until 1984, when the original 1-percent limit proved insufficient to cover expenses. 25X1

Recent Budgetary Reforms

In June 1983 at Stuttgart, EC leaders pledged to undertake fundamental reforms aimed at solving the Community's mounting financial problems, but we believe that after two years their accomplishments, while important symbolic first steps, have been limited. During 1984, the Ten agreed to a series of reforms that they publicly touted as major victories to help end the EC's budget problems. In our view, these

How the CAP Operates

The EC's Common Agricultural Policy was launched in 1962 and has become the centerpiece of the EC. From 1973 to 1984 annual EC spending on CAP supports averaged 69.3 percent of the EC budget. The CAP relies on five types of market intervention, all of which have budgetary implications.

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Price supports. *Each spring EC agricultural ministers set support prices for milk, cereals, beef, veal, pork, sugar, wine, and most fruits and vegetables. The key figure for each commodity is the intervention price, the price at which Community agents stand ready to support the market by buying unlimited quantities of products meeting EC quality standards. Intervention prices effectively set the floor for the EC market and for most products largely determine the final prices received by farmers. By world market standards, EC prices are extremely high; in 1981, for example, Community butter prices were 53 percent higher than world prices and beef prices were 52 percent higher. The most visible result of high intervention prices has been huge agricultural surpluses that the Community has stockpiled. The EC's butter "mountain" now stands at nearly 1 million metric tons, and the wine "lake" now contains almost 3 billion gallons.*

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Import levies. *Most products—cereals, sugar, milk products, and olive oil—are protected from foreign competition by a series of variable levies. The particular commodity entering the Community at the lowest price is charged a levy that is calculated daily and pushes the import price above the domestic price.*

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Export refunds. *Export refunds enable EC farmers to sell their higher priced goods on world markets without suffering a loss. They have increasingly been used by the Community to dispose of part of the stockpiles. In 1984, nearly 37 percent of CAP spending was earmarked for export refunds. In 1984, the Community provided export subsidies of $1.7 billion for milk products, $909 million for cereals, and $545 million for beef and veal.*

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Supplementary and fixed-rate aids. *These represent a small percentage of CAP spending on direct price supports, often paid in proportion to output or on the basis of the amount of land tilled. Unlike the support price mechanism, which guarantees high prices through market intervention, these aids provide direct subsidies to farmers.*

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Structural aids. *These are aids used for modernizing the farm sector. They are referred to in the EC budget as the CAP guidance section. In 1984 they represented about 3 percent of CAP spending.*

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reforms contain important flaws and represent typical EC compromises on the lowest common denominator of agreement. Some of the reforms—such as a new regime to cut milk production—hold promise, but EC members have managed to weaken them in their implementation. Others—such as a new system to impose mandatory spending controls—contain potential loopholes and are too vague to be effective. In addition, although the 1984 reforms may help push budgetary issues onto the back burner for a while, we believe the horsetrading that took place in the reform negotiations may have established precedents that will set the scene for renewed budgetary squabbling a few years hence.

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Limiting Dairy Surpluses

At the Agricultural Council meeting on 30-31 March 1984, farm ministers approved a five-year program—dubbed the "super levy"—that imposes quotas on milk production and stiff tax penalties on overproduction. The primary objective of the new dairy regime is to terminate the Community's open-ended guarantee to buy milk production. The dairy sector is the main culprit in CAP overspending; in 1984 over 32 percent

EC: Sources of Revenue

There are three main types of independent EC revenue sources. Collectively they are known in Community jargon as "own resources," to distinguish current methods of EC funding from the Community's early days when it had to depend on national contributions.

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Value-added tax (VAT) payments. *This is the most important source of EC revenue. The VAT is a method of indirect taxation on the use of goods and services by final consumers. Standard VAT rates vary from EC country to country, from 13 percent in West Germany to 25 percent in Ireland. Since 1975 EC members have paid up to 1 percent of their VAT proceeds to the Community annually. When the mechanism was first instituted, the EC used less than half of the VAT pool at its disposal; in 1982 it used 92 percent, and in 1983 it claimed 99.8 percent. In 1984 the VAT pool was exhausted. An increase in the VAT ceiling, or percentage of national VAT proceeds available to the Community, requires an amendment to the Treaty of Rome, and thus the approval of all 10 parliaments.*

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Customs duties. *The Community receives the duties collected through the Common External Tariff on nonagricultural goods imported from third countries. In theory, these are the purest form of "own resources" since they are simply collected by member states on behalf of the Community. The Commission even reimburses member states their collection costs.*

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Agricultural levies. *The Community also reaps the proceeds of the CAP levies that close the differential between world market prices for agricultural goods and EC threshold prices. In addition, the EC collects levies on the production and storage of sugar and isoglucose to help defray the costs of market support for those products.*

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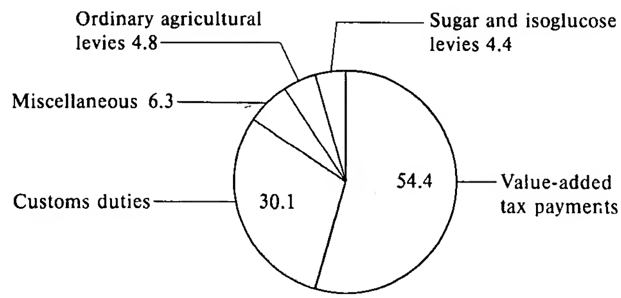
Figure 5
EC: Sources of Revenue, 1984

Percent
Total=US $20.9 billion



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of CAP guarantees went to milk products, compared with 11 percent for beef and veal, the next-highest category (see figure 6). 25X1

Although the new dairy regime will slow the growth of milk surpluses, it will not eliminate them. If anything, it is likely to ratify the existing state of persistent overproduction. The super levy's lowest annual quota, 98.4 million tons, is still well above current EC consumption of about 87 million tons. In our judgment, the program simply does not address the heart of the problem: unduly high support prices that have provided irresistible incentives for farmers to expand production. By the Commission's own conservative estimates, dairy support prices would have to be cut 12 percent to bring production into line with consumption. 25X1

The New Dairy Regime

The goal of the new regime was to cut marketing year (MY) [a] *1984 production to 99.2 million tons, down from an estimated MY 1983 production of 108 million tons. In MYs 1985-88, production will be cut further, to 98.4 million tons annually. The quota will be shared among EC members based on 101 percent of their 1981 production. Ireland—whose dairy sector accounts for 9 percent of GNP—has been granted an exception and will base its quota on its output in 1983, a more productive year. Each EC member will be allowed to determine just how its quota will be apportioned among farmers.*

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EC members will also be allowed to decide whether individual farmers or dairies will be subject to the quotas and held responsible for paying the penalty taxes. If a country chooses to hold farmers responsible, the farmers will be charged a tax equal to 75 percent of the value of all milk exceeding their quotas when they deliver it to dairies—in other words, they will be paid only 25 percent of the value of the milk over their quotas. The Netherlands, West Germany, and Northern Ireland have chosen this method of implementing the quotas at the level of individual farms. Most other EC countries will impose the quotas on dairies delivering excess milk to intervention agencies. The dairies will have to pay a super levy of 100 percent of the target price, a crippling disincentive since the dairies will receive nothing for the surplus milk they sell into intervention.

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[a] *The marketing year begins on 1 April of the stated year and ends on 31 March of the following year.*

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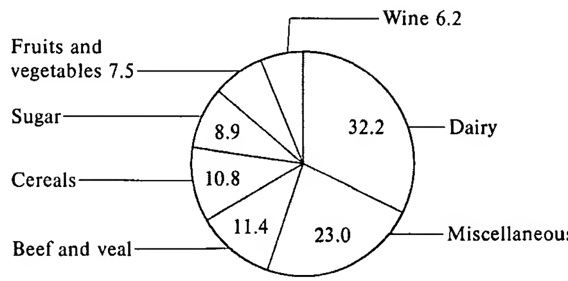
Preliminary production estimates for marketing year (MY) 1984 indicate that, in the first year of the super levy's operation, EC milk production was held roughly within the new quotas, although this was accomplished largely through distress slaughtering, which worsened the EC beef surplus. The Community's initial experience in implementing the super levy raises questions about the commitment of EC members to tough CAP reforms, however. Despite their earlier approval of the super levy, the Ten at first delayed collection of the levy, blaming administrative problems. In early December 1984, all members except Denmark voted in favor of a Council resolution asking the Commission to push the due date for the first payment back to March 1985, the end of the 1984 milk marketing year. Only West Germany made the original deadline for the first payment, 15 December 1984, and Bonn announced it would not make future payments unless other members do. 25X1

Figure 6
EC: Common Agricultural Policy Support Payments by Crop, 1984 [a]

Percent

Total=US $14.2 billion



[a] Excluding MCA payments.

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Press reports also indicate that Italy apparently attempted an especially ingenious method for sparing its farmers from the super levy. Instead of applying the quotas to farms or dairies, Italy claimed that because of its special circumstances it would implement quotas

only at the national level, in effect treating the entire country as one large dairy. The Commission suspected that Rome would then pay the tax penalty on overall Italian overproduction out of general government revenues, thus effectively destroying the practical impact of the new system on individual farmers. The Commission maintained that this would be an illegal national aid to agriculture, and it opened infringement proceedings against Italy that could have resulted in the case's being heard by the European Court of Justice. Under pressure from the Commission, Rome finally abandoned its attempt to nationalize its quota in February 1985. Although the Commission in return dropped its infringement proceedings, it did agree to allow EC members to transfer quotas among dairies in MY 1984, which may establish a precedent for future implementation of the super levy at the national level.

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Containing Agricultural Prices

The ministers also agreed at the March 1984 Agricultural Council to a package of MY 1984 farm prices that included an average price decrease of 0.5 percent, calculated in ECUs. Prices for meat, wine, olive oil, and most cereals were cut by 1 percent; milk and sugar prices were frozen at their MY 1983 levels. In addition, several aids and premiums were decreased.

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The ministers portrayed the unprecedented overall cut in ECU-denominated prices as especially tough. When translated into national currency terms, however, prices were actually boosted in seven countries and, for the Community as a whole, rose 3.3 percent. Despite the Community's attempt to hold the line on prices, the package remained costly by preserving strong price incentives for farmers to overproduce goods that must be purchased by EC intervention agencies.

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Thus far in 1985 the Community has again tried to whittle down farm prices, but without success. In January the Commission proposed a controversial MY 1985 price package with a 2-percent price rise for milk, cheese, and olive oil; a price freeze for meat, sugar, and wine; and a 3.6-percent price cut for wheat, barley, and rapeseed. West Germany has blocked final agreement on the package, however, rejecting it outright because Bonn maintains that the grain price cut is excessive. Since 31 March 1985, the beginning of the new marketing year, the MY 1984 price structure has been continued on an ad hoc basis while agricultural ministers have met periodically to try to break the deadlock.

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New Agricultural Monetary Measures

At the March Council meeting, EC foreign ministers also agreed to dismantle the most expensive elements of the Community's system of monetary compensatory amounts (MCAs)—an elaborate structure of cross-border taxes and subsidies aimed at neutralizing the effects of exchange rate fluctuations on CAP payments. So-called positive MCAs that recompensed West German and Dutch agricultural exporters for the higher price of their product—in foreign currency terms—caused by the strength of the West German mark and the Dutch guilder are being eliminated in three stages, beginning in April 1984 and ending in MY 1987. In addition, most negative MCAs will be eliminated beginning in MY 1984, and eventually only France will have a small negative MCA. Henceforth, CAP intervention prices will be linked to the Community's strongest currency, now the mark. The mark has tended to be the strongest EC currency since the inception of the European Monetary System because of low West German inflation and the strength of the West German economy.

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To ease the burden on West German farmers losing positive MCAs, Bonn has been authorized through 31 December 1988 to add up to 5 percent to its domestic value-added tax on agricultural products. By using this extra revenue to compensate its farmers for the loss of positive MCAs, West Germany is in effect creating a new national aid to agriculture. Another result is a partial shift of the financial burden of West Germany's agricultural support from the EC to West German consumers, who will pay higher food costs.

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Although billed as a significant moneysaving reform, the new monetary mechanism will give the EC little budgetary relief. The MCAs being phased out cost the Community $300 million in 1983. Moreover, the

Green Money

The CAP was originally designed in a period of fixed exchange rates. With the onset of floating rates in 1971, the Community had to design a system to insulate the intervention price structure—which farmers insisted should provide stable and predictable price support—from fluctuating exchange rates. The EC sets agricultural support prices based on a currency average, or basket—currently European Currency Units (ECUs)—and uses a special set of exchange rates—called green rates—to convert common ECU-denominated farm prices into national currencies. Green rates are fixed and do not reflect currency movements unless they are formally devalued or revalued.

This system holds domestic farm prices steady but puts farmers in countries with appreciating currencies at a competitive disadvantage when selling their products elsewhere in the Community. To counter the effects of currency fluctuations, the EC invented monetary compensatory amounts (MCAs). "Positive" MCAs apply to currencies that are strong relative to their green rates. They are applied as border subsidies on food exports and border taxes on food imports. Conversely, "negative" MCAs tax food exports and subsidize food imports to nullify the price advantages enjoyed by farmers in weak currency countries. MCAs are considered "fixed" for West Germany, Belgium, the Netherlands, Denmark, Ireland, and France, which narrowly limit their currency movements under the European Monetary System. Because their currencies fluctuate more widely, Italy, Greece, and the United Kingdom have variable MCAs recalculated weekly. As of 1 January 1985, only West Germany and the Netherlands had small positive MCAs. France, the United Kingdom, and Greece had negative MCAs, and no compensatory amounts were applied to other EC members, indicating that the Community felt that their green and market exchange rates were near parity.

The subsidy element of the MCA system cost the Community about $300 million in 1983. The system is also inefficient insofar as it encourages smuggling. Farmers with positive MCAs can collect an export subsidy when driving their goods across the border into a weak currency country, then smuggle the goods back home and reexport them for a second subsidy.

saving will be reduced in 1985 and 1986 because the Council also approved in March a special two-year compensation of $170 million for West German farmers to cushion them from the abrupt loss of positive MCAs. This EC compensation will be on top of any money paid to farmers through national aids.

Boosting VAT Revenues

At the Fontainebleau Summit in June 1984, EC leaders made an important breakthrough on the budget by agreeing to raise the VAT ceiling from 1 percent to 1.4 percent. The agreement calls for EC members to submit the enabling legislation to their parliaments at the same time they submit the legislation permitting Spanish and Portuguese accession to the Community. Under present arrangements, the agreement will thus have no impact on the 1985 EC budget. At Fontainebleau, the leaders envisioned the new VAT ceiling taking effect on 1 January 1986, with a further increase tentatively scheduled for 1 January 1987, the Commission's best guess as to when the 1.4-percent ceiling will be reached.

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Covering the 1984 Budget Shortfall

After much argument, and with the prospect of a suspension in CAP support payments looming, the Ten agreed in early October 1984 to a $760 million supplementary budget to tide the Community over until 1985. The stopgap measure consists of advances from member states to the Community, which are to be repaid once new VAT revenues are available. Since technically these are one-time loans to be reimbursed in full after a specified period, they do not violate the Community's balanced budget requirement. Although the sum involved is considerably less than the $1.4 billion requested by the Commission, it was enough to cover essential expenses. The scheme may set a precedent for future emergency EC funding.

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New Regime for "Budgetary Discipline"

An agreement on new budgetary discipline, reached by EC foreign ministers in November 1984, was the precondition the United Kingdom and West Germany set before they paid out their contributions to the supplementary budget. The new regime covers the entire EC budget, not just the CAP, and stipulates that the rate of spending growth over any three-year period must be kept below the rate of increase in Community revenues. 25X1

Under the new procedures, EC finance ministers—who until now have had little direct involvement in the budget process—will meet each year to agree on a "reference framework" for spending that will be based on the average growth of EC revenues in the previous three years. The Council agreed that the Community will strive to keep spending below the ceiling set in the reference framework. Should a particular EC policy threaten to violate the finance ministers' guidelines, the Commission—but not individual member states—can insist on its suspension. If spending on individual programs rises excessively despite the new budgeting procedures, the Ten have pledged to try to "claw back" spending in the succeeding two years. The new system is to begin in 1985, and thus will have its first impact on the 1986 budget. The Ten have agreed to review it one year before the Community reaches the 1.4-percent VAT ceiling, which means it may have to be scrutinized as early as 1986. 25X1

Enough loopholes exist in the agreement to suggest that it will have only a limited impact. Most important, the new procedures make wide allowances for exceptional circumstances that can permit higher spending. EC officials have indicated that these exceptional circumstances might include enlargement, the implementation of earlier Council resolutions on the disposal of surplus agricultural stocks, and aid for the least economically developed EC members. In addition, the new procedures carry little legal force. The United Kingdom had at first demanded an amendment to the Treaty of Rome to enforce budgetary discipline, but the new directive is simply a set of procedures that have been ratified by the Council but which can be ignored. 25X1

The European Parliament

The EC Commission prepares the draft Community budget each year. The draft budget then goes to the Council—which represents the 10 member states—and on for final approval to the European Parliament, which sits in Strasbourg, France, and consists of 434 directly elected members. The Parliament's budgetary discretion—one of its few powers—is twofold:

- *Within certain constraints, it can add spending to the Commission and the Council's budget proposals.*
- *It can reject the entire draft budget and require the Commission to submit a new one.* 25X1

The Parliament can add only to noncompulsory EC spending. The Treaty of Rome defines compulsory spending—over which the Parliament has no control—as spending required by the Treaty or by acts adopted in accordance with the Treaty. The Community has not developed an ironclad working definition of compulsory spending, but CAP price support and foreign aid stemming from treaty obligations are generally considered to fall in this category. Because the distinction between compulsory and noncompulsory spending mainly affects the extent of the Parliament's budgetary power, defining the two is more a political than a legal issue. Roughly speaking, only about one-fourth of EC spending is categorized as noncompulsory. 25X1

In accordance with the Treaty of Rome, each spring the Commission fixes the maximum rate of noncompulsory spending growth, which further limits the amount the Parliament may add to the following year's budget. The Treaty specifies the formula for deriving the maximum rate, which is based on the average increase in the previous year of the budgets of member states and the average increase in Community GDP. 25X1

If the Parliament seriously objects to the draft budget and is unable to work out compromises with the other institutions, it can reject the coming year's budget outright. This has happened twice, with the 1979 and 1985 budgets. The Treaty of Rome stipulates that, if the Parliament exercises its veto, the Community can spend in the new fiscal year according to a system of "provisional twelfths." Under this arrangement EC spending each month cannot exceed one-twelfth of the previous year's total budget. In effect, this freezes the level of overall EC spending until the Parliament adopts the new budget. In 1979 the EC operated on provisional twelfths until April. 25X1

On top of the new regime's weaknesses, it has also helped cause a dispute between the Council and the European Parliament. The Parliament objects to a Council-imposed ceiling on the budget, over which it exercises some legal control. In December 1984 the Parliament rejected the draft 1985 EC budget, in part to express its displeasure over the new budget discipline guidelines. The Treaty of Rome stipulates that until the Parliament approves the 1985 budget, the Community must spend on the basis of 1984 allocations. 25X1

Prospects

In our judgment, the EC will continue to be plagued by budgetary problems for years to come. Although we consider it unlikely, budget difficulties may resurface as early as this fall. The Ten must grapple with two budgetary issues this year: gaining parliamentary approval for the 1985 budget and ensuring that the EC fills the revenue gap that the Community will almost certainly face until the 1.4-percent VAT ceiling takes effect. 25X1

Quick Fixes

The Community should be able to win parliamentary approval of the 1985 budget by this summer, but the Council probably will have to yield some discretionary power to the Parliament under the new budget discipline regime. In addition, the Parliament almost

certainly will insist on a firm Council program for covering the 1985 revenue gap. Based on the 1985 draft budget and expected VAT revenues, the Commission estimates that the EC will fall some $2.1 billion short this year. The Parliament has charged that the Council was irresponsible in adopting a 1985 draft budget without providing sufficient funding, and this was another important reason for the Parliament's rejection vote. 25X1

During a Council meeting in late March 1985, the Ten agreed in principle to additional emergency financing for the rest of the year, which should satisfy the Parliament. The plan provides that, once the Council and the Commission agree on the exact size of the 1985 cost overrun, the gap will be filled by nonrefundable national payments. The Council made implementation of the plan contingent on the ratification by all 10 national parliaments of the 1.4-percent VAT ceiling, however. Significantly, the British rebate agreed to at Fontainebleau will be funded through these national payments. Should approval of the 1.4-percent VAT ceiling bog down in one of the national parliaments and the deal sour, the United Kingdom will almost certainly respond by cutting off all EC payments, which would plunge the Community even deeper into crisis. 25X1

In our view, the Ten probably will ratify the 1.4-percent VAT ceiling in time to avert another budget crisis this year and bring the new revenues on stream next January. The heads of government gave the new VAT ceiling a clear political endorsement at Fontainebleau, and, barring technical delays, the 10 national parliaments should not have difficulty ratifying the measure. With new revenues imminent, we doubt that the Ten will risk unraveling the budget and CAP reforms agreed to last year—which they have portrayed publicly as important victories for the Community—by allowing budget problems to regenerate this year. 25X1

Unresolved Problems

Once the 1.4-percent VAT ceiling is in place, the fate of the EC budget in the medium term will rest on the spending side, especially on the CAP. In our view, the new budgetary discipline regime is largely cosmetic and intended to placate the United Kingdom and West Germany, which, because of their outspoken public stands in favor of budgetary stringency, were politically committed to installing new measures. Given the centrality of the CAP to EC affairs, and the Community's past difficulty in reforming individual agricultural sectors such as dairy, wine, and grains, we doubt that the intentionally vague new budgetary discipline regime will place an effective lid on spending. Moreover, the inclusion of finance ministers in the budget process may further complicate and politicize the annual farm price negotiations. 25X1

Ironically, the new budget discipline regime may have the perverse effect of freezing—not lowering—the percentage of EC spending devoted to agriculture. The new regime is aimed at holding down the growth of the entire budget, not just the CAP. In the stiff competition for EC resources, Community farmers—who wield considerable political clout—will strongly resist reductions in their share of the budget. Indeed, we believe the Community will be tempted to cut less politically sensitive programs such as high-technology research and environmental programs to free money for CAP price supports. The only politically acceptable way for the Community to orient itself away from agriculture would be to increase the relative size of spending in other sectors by boosting the overall size of the budget, but this would violate the new budgetary regime. 25X1

Spanish and Portuguese entry into the Community is likely to place a further strain on EC finances.[2] According to Commission figures, full membership for the Iberian states will increase the number of EC farmers by 37 percent, raise Community production of fresh fruits and vegetables by 44 percent, and expand olive oil and wine production by 66 percent and 32 percent, respectively. The Community has tried to spread the costs out by calling for long transition periods and pressing tough terms on Spain and Portugal in the enlargement negotiations. Because some of the final details of Spain and Portugal's

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entry terms must still be ironed out, it is difficult to assess the budgetary implications of enlargement. The [redacted] 25X1

Although the cumulative effect of the recent CAP and budget reforms may relieve the financial hemorrhaging the Community experienced in 1983 and 1984, we expect that spending pressures will lead the EC to raise the VAT ceiling periodically. Fiscally conservative members such as the United Kingdom and West Germany, however, will probably resist large VAT increases to maintain leverage over the budget. We thus believe that the VAT ceiling will be pushed up in small increments—on the order of 0.2 to 0.4 percentage point—every two or three years. [redacted] 25X1

[redacted] 25X1

Implications

The EC's continuing fixation on its budget problems may weaken the Community and encourage an even more elaborate crazy quilt of national and regional policies. The agreement on the abolition of positive MCAs, which was billed as a budgetary measure, is an example of the EC's drift toward reliance on national rather than Community programs to support agriculture. [redacted] 25X1

[redacted] 25X1

The EC budget crisis, and the CAP's continued drain on Community resources, bode ill for EC spending on nonagricultural programs. Many prominent Community spokesmen, led by President Mitterrand when France held the EC presidency in the first half of 1984, have urged the Ten to put more emphasis on the development of high technology. Unless the EC's budget picture changes dramatically, however, the prospects for significant EC expenditures on new high-technology ventures are poor. [redacted] 25X1

[redacted] 25X1

[redacted] Lacking Community-wide incentives to develop high technology, EC firms may have trouble raising capital, and they are likely to have difficulty competing with more technically advanced US and Japanese companies. [redacted] 25X1

In our view, the EC budget crisis is symptomatic of deeper problems that will impede the long-term institutional development of the Community. We believe that the budget imbroglio demonstrates that EC members lack the political will to move the Community substantially toward greater integration. [redacted] 25X1

[redacted] 25X1

EC members have generally adopted a cautious approach to Community programs, sidetracking bold

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new initiatives. Among these have been recent proposals to abolish the veto and move to a system of majority voting, attempts at CAP reform to reorient the EC away from agriculture, proposals for beefing up the European Monetary System and expanding the international use of the European Currency Unit, and attempts at reaching joint foreign policy positions. [redacted]

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The Budget Crisis and US-EC Relations

Continuing EC budgetary problems will tempt the Community to try to externalize its financial troubles, and, in our view, the United States is likely to be a primary target. The EC may try both to shift the financial burden of CAP reform onto third countries and to find outside scapegoats for domestically unpopular decisions. The Community's early 1984 proposal to restrict imports of US-produced corn gluten feed, now the subject of US-EC GATT consultations, is a prime example of such a policy. It is aimed both at increasing EC consumption of domestically produced grain and discouraging dairy production by driving up feed costs. The proposal, however, serves an even more important political purpose. Recent remarks by a highly placed Commission official indicate that the proposal is intended to appease EC dairy and grain farmers who must bear the brunt of CAP reforms. EC farmers have grumbled that US feedstuff producers have continued to profit from corn gluten sales while EC farmers face restrictions on production. Budget problems may also lead the EC to resurrect proposals for a tax on vegetable oils other than olive oil. This would hit US soybean sales to the Community ($2.2 billion in 1983), encouraging domestic EC butter and olive oil consumption and raising new agricultural revenues. [redacted]

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[redacted]

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We believe that, on balance, the EC's preoccupation with its domestic problems will be detrimental to US interests. Beyond encouraging further EC agricultural protectionism, continued EC agricultural overproduction is likely to lead the Community to try to export aggressively to third markets. At the same time, the United States probably will find it more difficult to deal with the Community. Bickering among the Ten will make it more difficult for them to take strong and united stands on trade, monetary, and foreign policy issues. [redacted]

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[redacted]

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